STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program

Expanding Small Business Access to Capital

Submitted to the

SUBCOMMITTEE ON FINANCE & TAX

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

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The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Subcommittee on Finance and Taxation about our proposals to improve access to capital by small businesses.

NADCO is a membership organization representing the Certified Development Companies (CDCs) responsible for the delivery of the SBA 504 program. We represent more than 260 CDCs and more than 200 affiliate members, who provided more than 98% of all SBA 504 financing to small businesses during 2008, as well as many other small business programs and services in their communities. CDCs are for the most part not-for-profit intermediaries with a statutory mission of community and economic development achieved through the delivery of the SBA 504 and other economic development programs and services customized to the needs of their respective communities.

NADCO's member CDCs work closely with SBA and our lending partners (generally banks and federal credit unions) to deliver what is certainly the largest and most successful federal economic development finance program in history (over two million jobs, $44 billion in authorized 504 loans and the leveraging of over $50 billion in private investment since 1986).

NADCO would like to thank Chairman Schrader, Ranking Member Buchanan, and the entire Sub-committee, for continued support of small business in America, the CDC industry and the 504 program. The Committee on Small Business has worked closely with SBA and our industry to ensure the availability of this valuable economic development program to small businesses for more than twenty years.

NADCO will provide comments today on the proposals we have made to the Subcommittee to improve the 504 program in order to increase access to long term capital by small businesses during and following this recession. Our industry thanks the Subcommittee for including in its legislation these program enhancements to expand access to long term, low cost capital for small businesses.

<u>Reducing 504 Program Costs for Small Businesses:</u>

NADCO has just been informed that the FY 2010 SBA budget increases the cost of access to the 504 program for small businesses by 38.9 basis points per annum. Further, with the nation's unemployment rate being a major factor in the SBA's "econometric" subsidy model, it is almost a certainty that the borrower fee for FY 2011 will also increase. For the average 504 borrower, this represents an increased interest cost of almost $50,000 for the life of their loan. For FY 2011, this figure may far more than double. These cost increases will hit our new borrowers just at the time our national economy needs these companies to expand, create jobs and help pull the country out of the recession. These fee increases will clearly negate the benefits of the benefits of the stimulus bill. We reduced the cost to borrowers in March 2009 and then will significantly increase the cost in October 2009, and likely increase the costs again in October 2010.

Since FY 1997, the 504 program has been at zero subsidy; that is to say, fees paid by small business borrowers, CDCs and first mortgage lenders have covered the entire cost of the program. Until passage of the stimulus bill in February of this year, no taxpayer funds have been appropriated for the program in over ten years. While we have requested a more detailed discussion with SBA's subsidy experts, an analysis of the OMB Federal Credit Supplement reveals that SBA is projecting that loan defaults for 504 will increase from 3.5% for FY 09 to over 7.3% for FY 2010. Together with the unemployment rate increase, these two factors may well account for the majority of the fee increases over the next two years.

NADCO is concerned about this forecast of the program default rate. Surveys of our CDC membership and information on bank credit underwriting lead us to a very different conclusion than the SBA has drawn for this critical factor. In fact, both bank's AND SBA's own underwriting of 504 loans have become far more conservative during this recession. The "credit box" has become much tighter, and only the strongest small businesses are now qualifying for new loans. Further, with most businesses more carefully husbanding their cash, demand for fixed plant expansion is coming from only the stronger small businesses. Finally, appraisers have become much more conservative in their valuations of commercial real estate, making expansion capital of any kind much more difficult to obtain.

Combining all these factors, it is clear that the FY10 loans we make to small businesses may be among the best and most conservatively underwritten in the twenty-two year history of 504 lending. NADCO strongly believes that loan defaults for the 2010 loans will substantially <u>decline</u>, not go up, as now forecasted by SBA's subsidy modelers.

If nothing is done by Congress, the result will be identical to what occurred in FY 1997 when OMB grossly overestimated the defaults and cost thousands of small businesses millions in inflated guarantee fees. In FY 2010 we will see borrowers paying unnecessarily high program fees at the worst time: when they need access to affordable 504 loan capital so they can preserve their cash for working capital to undertake their company expansion and create jobs. With inflated guarantee fees for both FY 2010 and 2011, almost 20,000 small businesses will pay millions in extra fees to SBA over the entire twenty years of their 504 loans. The 504 program will become less and less effective for small businesses creating new jobs.

We ask the Subcommittee to consider the impact of these increased guarantee fees on the very small businesses that are the job creators that will lead America out of this recession. NADCO believes that the only way to restore the fairness of this subsidy process is for Congress to step in and appropriate sufficient federal funds to offset these fees. We request this be taken up by Congress as soon as possible in order to negate the impact of this subsidy fee on our borrowers for FY 2010.

<u>Reaching Out to More Small Businesses With New Capital:</u>

The Congress and the Obama administration have worked hard to put more fixed asset and working capital in the hands of small businesses hard pressed by this recession. Our industry thanks both the Congressional Small Business Committees for taking a leadership role by adding key programs to the stimulus bill earlier this year that are beginning to impact capital access and job creation.

However, our industry believes that more should be done quickly to have even more impact. Even as SBA worked to implement new programs and fee reductions created through the stimulus bill, the loan eligibility and underwriting policies set forth by SBA that are so critical to maximize the effectiveness of these programs were drifting towards more conservative interpretations on numerous issues. NADCO thanks the Subcommittee for accepting a number of recommendations to truly expand the availability of 504 funding to more small businesses. These include:

<u>Increase the maximum 504 loan size</u>: In order to reach more borrowers, the limit for a regular 504 loan should be increased from $1.5 million to at least $3.0 million (and possibly more), and the limit for

critical public policy loans should go from $2.0 million to at least $4.0 million. Commercial real estate construction costs have increased substantially in the last five years, and the program benefit must keep up with these costs for small businesses.

Allow use of HELOCs for owner 504 equity access: SBA had moved to restrict 504 borrowers from using proceeds of their Home Equity Lines Of Credit for their cash injections into their 504 projects, a practice used for over twenty years with no documented increase in credit risk. While this new SOP change has been temporarily placed in abeyance, we are seeking a more permanent solution to this issue. This option for use of borrower's home equity lines must be continued through legislated guidance to SBA.

Assist businesses in low income areas: The benefits of the public policy loan limits should be made available to small businesses located in low income areas, to include those that would be eligible for new markets tax credits. Many traditional lenders have moved away from making loans in these areas due to perceived added risk. More capital must flow to these small businesses that create jobs in areas of low income and extremely high unemployment. This is a core mission of the 504 program.

Combine the benefits of certain public policy goals: Small businesses owned jointly by minorities, women, or veterans (all now individually public policy qualified) should be able to qualify for a "combined" benefit if they own at least 50% of the business, rather than the current regulatory restriction of 51%. This will enable many more small firms to obtain added capital.

Maximize both 504 and 7(a) loan eligibility for a borrower: Small businesses typically need added working capital when building a new larger 504 project, yet this is frequently restricted under current SBA regulations. Particularly in this credit crisis, we must make this capital available for inventories, salaries and business operating expenses, in ADDITION to the funds for the building construction.

Uniform leasing policy: Small businesses should be able to lease out 50% of their space, whether it is newly constructed or an existing building, for both the 504 and 7(a) programs, and this will actually reduce credit risk while providing added potential expansion space for these growing firms well into the future.

Acquisition of stock: Some small businesses being acquired by new owners should be allowed to make the fixed asset transfer through a stock sale, so long as the assets are 504 eligible.

Definition of "rural" areas: SBA continues to apply outdated population parameters to rural areas, which restricts 504 from assisting rural borrowers through public policy loans. We request that the more current USDA definitions of "rural" areas be applied to SBA programs to increase the availability of capital in these areas.

Controling and Reducing Loan Losses for the 504 Program:

Loan defaults and losses have increased for 504, as for all other commercial lending – both public and private – during this recession. NADCO believes it is imperative for changes to be made to control these losses in the future. We appreciate the Subcommittee including the following recommendations:

CDC responsibilities for loan liquidation and recovery: SBA's limited liquidation staff is being overwhelmed with loan defaults, which is leading to higher loss rates for 504. In turn, this will result in higher subsidy costs and fees for future borrowers. Qualified CDCs should perform liquidation and recovery work, and SBA should simply compensate CDCs for staff liquidation work from the certain increased recovery amounts, as their own regulations require (which have not been funded by the Administration).

Additional equity injections: To reduce debt service costs, some borrowers would like to have smaller private bank first mortgages (always at a higher cost to the borrowers than the federal government's second position) and larger 504 second mortgages. The requirements for bank participants should be more flexible to reduce overall project debt costs, which will enable borrowers to save cash for working capital, and almost certainly result in lower delinquencies and loan defaults.

Collection and accounting for defaulted 504 loans: Accounting for defaulted 504 loans, as well as new secondary work-out loans with borrowers, should be continued at the program's efficient and highly automated Central Servicing Agent. This will result in timely, accurate loan accounting and portfolio servicing, and enable CDCs to service these notes more rapidly and effectively. This will both reduce costs for SBA and increase overall recoveries from 504 defaults.

Reserve requirements for Premier Certified Lender CDCs: The pilot amortization program for calculation of PCLP loss reserves should be re-instated and made permanent. While this will reduce the cash reserve requirements for participating PCLP CDCs, it will attract more CDCs to this program that enables both improved borrower service and reduced loan losses for SBA from defaulted 504 loans.

Making SBA Programs More Relevant and Productive:

Loan volume for both the 504 and 7(a) guarantee programs has improved since passage of the stimulus act, but many of those benefits are just now being implemented by the SBA. However, in spite of the stimulus bill, both programs are still down as much as 40% from their highest levels two years ago.

A substantial part of this volume loss is clearly due to this historic recession with small businesses pulling back on demand for long term capital. But part may also be due to SBA, and even our own lending industries, failing to fully respond in innovative new ways to the ever-changing needs of small business financing. As we have seen with our inability to convert equity to working capital, and the ever more conservative policies on loan programs, it is possible that SBA's programs are becoming less relevant as small businesses are pushed to find other, and often more expensive, means of funding their growth and job creation.

Each of these guarantee programs is over twenty years old, and an environment of restrictive and potentially unnecessary regulations has evolved within the Federal bureaucracy. With this new administration, and the fresh thinking from senior policymakers it is attracting, NADCO sees an opportunity to break out of some of the old program's structure and bureaucracy. We see the chance to work with this new leadership team, and with the new Congress to expand the reach of the many benefits of both 504 and 7(a) to more borrowers with different capital needs in new and leading edge industries that will be the job creators for the next fifty years.

In order to begin a "re-thinking" of the program, its ability to serve small business, and an expansion of its benefits, NADCO believes that there must finally be established the organizational parameters and control guidelines for Certified Development Companies that deliver the 504 program to the nation.

The very definitions of our industry and its financing services should not be left to the sometimes arbitrary evolution of regulations that are designed to control the "lowest common denominator" of the program.

NADCO has carefully evaluated the existing industry structure and concluded that there is a need for codification of key facets of the industry and key program components. Implementation of the following recommendations will firmly establish operating guidelines for our industry:

<u>Certified Development Company structure</u>: Low cost program delivery is at the core of 504's benefits for small business borrowers. As SBA and our industry seek to grow the delivery organizations for 504, the program should continue to be delivered by not-for-profit, community-based organizations that are focused on economic development in their local areas. NADCO has created a series of recommendations that address this goal, and through codification, make it an absolute requirement for all new CDCs. Some of these recommendations mirror beneficial SBA rules, while others are completely new requirements that will maintain the advantages of today's low cost delivery of 504.

<u>CDC management and ethical structure</u>: With the recent corporate "implosions" in the financial services industries that led to many of the reasons for this credit crisis, NADCO strongly believes that there must be codified requirements for the ethical and service standards of the CDC industry. Our industry has a long history of focus on community benefits, rather than the profit goals of traditional private lenders. In order to maintain this focus, these recommendations should be implemented to maintain these standards for the benefit of our future borrowers.

<u>Multi-state service by CDCs</u>: Some of the current industry structure has evolved on a haphazard basis without careful consideration of small business needs in individual communities. "One size" does not fit all communities, and the expansion of CDC services must be carefully structured. NADCO makes a series of recommendations to enable Congress to provide definitive guidance for the future.

<u>504 Debenture definition and clarification</u>: The key component of the 504 program benefits is access to the capital markets for long term loan funding. Our low cost of debt is derived from the program's long term consistency of its funding security structure. Our security's portfolio performance has led to investment attractiveness by a very broad segment of major corporate investors and financial institutions, based both in the U. S. and overseas. This belief in our consistent performance and portfolio structure has directly led to lower interest rates for many years. For example, in spite of this credit crisis, our July 2009 interest rate for our borrowers was the second lowest in the twenty-three year history of 504. So even as Fortune 500 corporations are having trouble finding funds at ANY cost, the 504 program continues to function as the "window to Wall Street" for thousands of small businesses; providing funds on long terms and at the lowest possible cost.

The consistency of the funding security, known as the Development Company Participation Certificate, must be maintained in the future, regardless of the political changes that occur from administration changes. Modification of our security's terms will result in increased interest costs for our borrowers. NADCO requests that Congress maintain the stability of our funding mechanism by codifying the payment schedules of principle and interest for our securities. This will remove the potential uncertainty of the borrower's payment streams, maintain the low interest rates, and insure long term access to the credit markets.

CONCLUSIONS:

For many years, 504 has been an extremely cost effective capital access program for thousands of growing small businesses that are the core job creators of the American economy. The program was in such demand that for several years its growth rate exceeded 20% each year. As the country slid into recession, many small business owners decided they could not take a risk of continued growth of their firms, so they stopped borrowing all but the necessary working capital to maintain their existing operations.

It is the sense of both SBA and NADCO that "the dam is about to break". That is to say, many small businesses are concluding that an economic turnaround is beginning to happen. You can see it in the growth of the investment markets. We can see it in the calls that CDCs are beginning to get about the loan program. Our "pipeline" of loan projects is beginning to come back. Perhaps it is stimulus working; maybe it is simply the upturn of the American business cycle, but it's there, and it's growing.

The 504 program is over twenty-two years old, in its basic form. But the need for long term capital has not changed in those years, and 504 remains as relevant and important as the day it came out. NADCO has not proposed a radical change of direction for 504, but an incremental update and upgrade of a very successful capital access program that for over ten years has cost the taxpayer nothing.

The changes we urge Congress to make will maintain the stability of the "good", correct the "bad", and get rid of the "ugly". These will make 504 an improved source of capital at just the right time for our economy, as small businesses begin to ask for long term fixed asset and plant expansion funding. With these changes, and rapid implementation by SBA, 504 will be just the right program at just the critical time for small businesses. We ask Congress to pass these recommendations, and work with SBA and our industry to help restore the American dream of business ownership and entrepreneurship.

Thank you for your support for the past twenty-two years. You are responsible for our success today!